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For Richard

The Two Roles of Bankruptcy Law

BANKRUPTCY LAW has been in existence, although intermittently, for almost as long as credit. Its origins can be traced back to the days of Roman law; indeed, its name is derived from statutes of Italian city-states, where it was called *banca rupta* after a medieval custom of breaking the bench of a banker or tradesman who absconded with property of his creditors.[1] After a spotty start in this country, it has been a fixed feature of our legal landscape since 1898.[2] But only with the 1980s has it grown in popular and legal prominence. As it becomes more visible, bankruptcy law has become more controversial and its perceived usefulness more widespread. It is fashionable, for example, to state that keeping firms in operation is a goal of bankruptcy law. It is likewise fashionable to see bankruptcy law as embodying substantive goals of its own that need to be "balanced" with (among others) labor law, with environmental law, or with the rights of secured creditors or other property claimants.[3]

1. Treiman, "Acts of Bankruptcy: A Medieval Concept in Modern Bankruptcy Law," 52 *Harv. L. Rev.* 189 (1938). Bankruptcy was transplanted to England in 1542, when Parliament enacted an "Act Against Such Persons As Do Make Bankrupt," 34 & 35 Henry VIII, ch. 4 (1542). See generally Treiman, "Escaping the Creditors in the Middle Ages," 43 *L.Q. Rev.* 230 (1927).

2. Congress passed the first bankruptcy act in 1800, 2 Stat. 19; it was repealed in 1803. It was next introduced in 1841, 5 Stat. 440, and was repealed eighteen months later. Congress passed another bankruptcy act in 1867, 14 Stat. 517; it was repealed in 1878. The Bankruptcy Act of 1898 was the first "permanent" bankruptcy statute in this country; it survived (with substantial amendments, particularly in 1938) until replaced by the current Bankruptcy Code in 1978. See generally C. Warren, *Bankruptcy Law in United States History* (1935).

3. For an example of a case that sees bankruptcy law's mission as that of keeping firms in operation and sees a corollary need to limit the protections accorded secured creditors,

All of these propositions are derived from an essential truth: bankruptcy law *can* be used to keep firms in operation, and bankruptcy law inevitably touches other bodies of law. But none reflects bankruptcy law's historical function, and insufficient attention has been devoted to how importing these other policies into bankruptcy will affect its long-standing role. Through this book I hope to establish the importance of bankruptcy law in meeting its historical goals—and the limits that notion implies for bankruptcy policy. My view of what bankruptcy law exists to do is, I believe, virtually unquestioned. But I believe that this widely accepted view of what bankruptcy law should be doing also carries with it certain limits, suggests certain things it should *not* be doing. Just as too many spices can spoil the soup, so, too, including too much in bankruptcy law can undermine what everyone agrees it should be doing in the first place.

Bankruptcy law can and should help a firm stay in business when it is worth more to its owners alive than dead. That is a far cry, however, from saying that it is an independent goal of bankruptcy law to keep firms in operation. Not all businesses are worth more to their owners—or to society—alive than dead, and once one recognizes that, one has to identify *which* firms bankruptcy law should assist and why. Saying that bankruptcy law "exists" to help keep firms in operation helps not at all in drawing that line. Instead, a theory of what bankruptcy law can and should do is necessary.

Bankruptcy law, moreover, because it affects all areas of the legal landscape in adjusting rights among creditors and other owners, must deal with labor law, environmental law, and tax law and with the rights of secured creditors and other property claimants. All of these people have contractual or statutory rights to assert claims against a debtor and its assets. As such, they are inevitably affected by bankruptcy law. But it is one thing to say that they are affected by bankruptcy law and quite another to see bankruptcy law as containing a set of substantive legal entitlements against which these other rights must be compromised. Before one jumps to the conclusion that bankruptcy policies need to be balanced with these other policies, one has to be clear what it is that bankruptcy law can and should do—and what it cannot and should not do.

In analyzing bankruptcy law, as with any other body of law, it helps to start by identifying first principles. Those principles can then be de-

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see *In re* South Village, Inc., 25 Bankr. 987 (Bankr. D. Utah 1982), an opinion written by Ralph Mabey, perhaps the most respected bankruptcy judge on the bench at that time.

veloped by defining their potential operation in the existing social, economic, and legal world to identify precisely what bankruptcy law should encompass, how it can accomplish its goals, and the constraints on its ability to do so.[4] That normative view of bankruptcy law can then be contrasted with the Bankruptcy Code as enacted to see whether and to what extent the existing regime follows the path the principles suggest is the proper one.

The point of this book is to suggest what the underpinnings of bankruptcy law should be and then to apply that learning to a variety of issues while testing the current provisions of the Bankruptcy Code against them. This approach is not unique. In fields as disparate and complex as antitrust, oil and gas, intellectual property, and corporate finance, analysis of discrete legal problems usually begins with a look at the theoretical framework that the law is built upon.[5] But this approach *is* almost unique to bankruptcy law. Much bankruptcy analysis is flawed precisely because it lacks rigor in identifying what is being addressed and why it is a proper concern of bankruptcy law. For that reason, when a new and urgent "problem" is discovered in the context of a bankruptcy proceeding, courts, legislators, and commentators all too often approach its resolution in an ad hoc manner, by viewing bankruptcy law as somehow conflicting with—and perhaps overriding—some other urgent social or economic goal.

I believe that this approach is fundamentally mistaken. Bankruptcy law, at its core, is debt-collection law. This is what we all agree on. When firms or people borrow, things sometimes do not work out as hoped.

4. Bankruptcy law is federal law, not state law. See U.S. Constitution, Art. I, Sec. 8, cl. 4. Its placement there has to do with notions of limits on the territorial power of state courts in our federal system. In a typical credit transaction, for example, a debtor residing in Illinois may borrow money from credit companies located in North Carolina and may own property situated in California. Illinois' power to affect the right of a North Carolina credit company to levy on property located in California may be limited. See, e.g., International Shoe Co. v. Washington, 326 U.S. 310 (1945). This notion applies both to creditor remedies and to discharge. See Ogden v. Saunders, 25 U.S. (12 Wheat.) 212, 358–68 (1827) (discharge under one state's law is no defense to an action brought by citizens of another state in another state's courts). The same problems can be replicated internationally, where, for example, the automatic stay will not affect creditors without "contacts" in the United States from pursuing property outside its borders. Here, comity is necessary. See §304.

5. See, e.g., R. Bork, *The Antitrust Paradox* (1979); R. Posner, *Antitrust Law: An Economic Perspective* (1976); V. Brudney & M. Chirelstein, *Cases and Materials on Corporate Finance* (2d ed. 1979); Libecap & Wiggins, "Contractual Responses to the Common Pool: Prorationing Crude Oil Production," 74 *Am. Econ. Rev.* 87 (1984); S. McDonald, *Petroleum Conservation in the United States* (1970); Friedman, "The Economics of the Common Pool: Property Rights in Exhaustible Resources," 18 *UCLA L. Rev.* 855 (1971).

For any number of reasons—from bad luck, crop failure, unexpected tort liability, dishonesty, or whatever—it is inevitable that some who borrow will not be able to repay what they owe. In a world in which creditors can call on the state to take a debtor's assets from it, it is necessary to establish what to do when debts are greater than assets. Two questions arise: (1) do we place limits on what creditors can take from their debtors; and (2) how do we decide rights among creditors when there are not enough assets to go around?

Much debt-collection law addresses these questions. Bankruptcy law does too, but it does so against the backdrop of other debt-collection law. Indeed, bankruptcy law is an ancillary, parallel system of debt-collection law. That position both defines its usefulness and sets its limits. Bankruptcy law historically has done two things: allowed for some sort of a financial fresh start for individuals and provided creditors with a compulsory and collective forum to sort out their relative entitlements to a debtor's assets. The policy relating to discharge and notions of a fresh start does in fact represent an independent substantive policy that is enacted through bankruptcy law and that must be balanced with other concerns, most notably the notion of open access to the credit markets in the first place. It addresses the question of whether limits should be established on what creditors can get from their debtor.

This substantive policy of a financial fresh start, although important when dealing with debtors who are human beings, is, however, also limited in an important respect. When firms rather than individuals are involved, neither bankruptcy law nor other law places limits on what creditors can get from their "debtor" precisely because the debtor is a fictional legal being. To talk about the need of a corporation or other business entity to use bankruptcy in order to have a fresh start is to conflate a number of issues, none of which have anything to do with giving an honest but unlucky individual a second financial chance. We might care that the assets of a corporation be used effectively, but how assets are used is a question distinct from giving those individuals who "own" them a second chance. There is no need to give a corporate charter a fresh start. When the unit involved is a corporation, the "debtor" is always shorthand terminology for something else—shareholders, managers, workers, or whatever—and we should realize that this something else is what we are talking about. The question of why we give individuals the right to a financial fresh start—and one that they cannot waive by contract (although they can in fact waive it, and a number of other rights, in other ways—such as by commiting murder)—is, to be sure, important, and its answer is somewhat uncertain and controversial. We will return to it in Chapter 10.

For the discussion in the first nine chapters of this book, I set aside the question of a financial fresh start for individuals. The statement that a corporation needs a fresh start reflects something very different—the view that the corporation should continue what it is doing. That issue is one of how assets should be used by those that own them, not one of giving a human being a right to renew his financial life.

The question of how assets are used is the focus of the other principal role of bankruptcy law, and working out its implications will consume our attention for the first nine chapters of this book. This role of bankruptcy law—historically its original function—is that of bankruptcy as a collective debt-collection device, and it deals with the rights of creditors (or owners) inter se. But it is first necessary to be precise what that means. Once one sets aside the question of the need of individuals for a financial fresh start, the remaining principal role of bankruptcy law has been and should be more procedural than substantive. That goal is to permit the owners of assets to use those assets in a way that is most productive to them *as a group* in the face of incentives by individual owners to maximize their own positions. Not all debt-collection rules are created equal. The rules governing debt collection can actually affect the total amount of the assets available to the creditors. When one is dealing with firms, the question is how to convert ownership of the assets from the debtor to its creditors, not how to leave assets with the debtor. But the process of conversion is costly. Bankruptcy law, at its core, is concerned with reducing the costs of conversion. This is the accepted starting point of bankruptcy law—and also the source of the limitations on what bankruptcy law should do. It is that goal, to which the bulk of bankruptcy law and the majority of the provisions of the Bankruptcy Code are devoted, and its associated limitations to which we turn first.[6]

6. One working assumption needs to be set forth. The lessons of the normative model I will be using in the first nine chapters are sometimes dismissed by people who believe that they are based on "unrealistic" assumptions and, particularly, that they assume a degree of rationality or calculation that simply is not present. In their present form, however, none of these criticisms is focused enough to justify dismissal of this normative model. Cognitive and volitional shortcomings are more relevant to an analysis of individual behavior—the sort of behavior that discharge deals with—than to an examination of institutional or market behavior. Investments by firms do have market constraints. Firms that systematically act impulsively or underestimate the risks of investments might, to be sure, be weeded out and replaced by firms that calculate risks more carefully. The result seems, however, to be welcome, not undesirable. Remember that the financial failure of

a corporation is distinct from the financial failure of the individuals who own it. When focusing on the latter question, we are in the realm of a financial fresh start for individuals, a topic we put aside for now. As for the former question, there is not much reason to think that the cognitive or volitional biases of individuals will lead to any systematic bias in the market's pricing mechanisms. If, for example, such behavior leads individual investors to react overly enthusiastically to a biotechnology firm's latest public offering, more skilled investors will be able to capitalize on that. Because of the likely presence of such skilled investors, aggregate (that is, marketplace) price levels at the end of the day should show no sign of any systematic underestimation of risks. It is that factor that allows us to defer an examination of individual factors until Chapter 10.

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The Role of Bankruptcy Law and Collective Action in Debt Collection

Bankruptcy law and policy have been subject to long-standing debate. This debate is not so much about whether bankruptcy law should exist at all but about how much it should do. All agree that it serves as a collective debt-collection device. Whether, when firms are involved, it should do more is the crux of the dispute. I plan to start by establishing in this chapter what accepted wisdom already acknowledges—that bankruptcy's system of collectivized debt collection is, in principle, beneficial. Most of this book will then be concerned with exploring how that benefit can be realized and, as importantly, how viewing bankruptcy as a collectivized debt-collection device imposes limits on what else bankruptcy can do well. It is in the latter area that the most conflict arises. It exists because bankruptcy analysts have failed to follow through on the first principles of establishing a collectivized debt-collection system. To show why bankruptcy's principal role limits what other functions it can usefully perform is the objective of this book. Toward that end we shall first examine why bankruptcy law *should* be doing what everyone takes as a given.

Bankruptcy law is a response to credit. The essence of credit economies is people and firms—that can be called *debtors*—borrowing money. The reasons for this are varied. In the case of individuals credit may serve as a device to smooth out consumption patterns by means of borrowing against future income. In the case of corporations and other firms it may be a part of a specialization of financing and investment decisions. And just as the reasons for borrowing are varied, so, too, are the methods. The prototype creditor may be a bank or other financial institution that lends money, but that is only one of many ways in which credit is extended. An installment seller extends credit. So does a worker who receives a paycheck on the first of December for work performed in November. The government, in its role as tax collector, also extends credit to the extent that taxes accrue over a year and are due at the end. Similarly, a tort victim who is injured today and must await payment until the end of a lawsuit extends credit of sorts, although involuntarily and (probably) unhappily. Finally, credit is not extended just by "creditors." First-round purchasers of common and preferred stock of a corporation are also lending money to the debtor. Their repayment rights are distinct (they are the residual claimants), but it is proper to view them, too, as having defined rights to call on the assets of the debtor for payment.

Whatever the reasons for lending and whatever its form, the terms on which consensual credit is extended depend to a substantial extent on the likelihood of voluntary repayment and on the means for coercing repayment.[1] We are not concerned here with the means for getting paid when the debtor is solvent—when it has enough assets to satisfy all its obligations in full—but is simply mean-spirited or is genuinely disputing whether it has a duty of payment (as the debtor might be with our putative tort victim or with a supplier who the debtor believes sold it defective goods). The legal remedies for coercing payment when the debtor is solvent concern the rights of a creditor to use the power of the state in pursuit of its claim. This is a question of debtor-creditor law and one to which bankruptcy law historically has had nothing to add, directly at least.

Bankruptcy law can be thought of as growing out of a distinct aspect of debtor-creditor relations: the effect of the debtor's obligation to repay Creditor A on its remaining creditors. This question takes on particular bite only when the debtor does not have enough to repay everyone in full. Even then, however, a developed system exists for paying creditors without bankruptcy.[2] The relevant question is whether that existing system of creditor remedies has any shortcomings that might be ameliorated by an ancillary system known as bankruptcy law.

To explore that question, it is useful to start with the familiar. Creditor

1. The terms of involuntary credit, such as tort claims (and perhaps things such as tax claims, too), are not set by negotiation and thus are less likely to be affected by matters such as the likelihood of voluntary repayment or the means for coercing repayment. Other interests, such as the deterrent effect of tort rules, may, however, be affected. See Schwartz, "Products Liability, Corporate Structure, and Bankruptcy: Toxic Substances and the Remote Risk Relationship," 14 *J. Legal Studies* 689 (1985); Halpern, Trebilcock, & Turnbull, "An Economic Analysis of Limited Liability in Corporation Law," 30 *U. Toronto L. Rev.* 117 (1980); Note, "Tort Creditor Priority in the Secured Credit System: Asbestos Times, the Worst of Times," 36 *Stan. L. Rev.* 1045 (1984).

2. See generally S. Riesenfeld, *Creditors' Remedies and Debtors' Protection* (3d ed. 1979).

remedies outside of bankruptcy (as well as outside other formal, nonbankruptcy collective systems) can be accurately described as a species of "grab law," represented by the key characteristic of first-come, first-served. The creditor first staking a claim to particular assets of the debtor generally is entitled to be paid first out of those assets.[3] It is like buying tickets for a popular rock event or opera: the people first in line get the best seats; those at the end of the line may get nothing at all.

When the issue is credit, the ways that one can stake a place in line are varied. Some involve "voluntary" actions of the debtor: the debtor can simply pay a creditor off or give the creditor a security interest in certain assets that the creditor "perfects" in the prescribed manner (usually by giving the requisite public notice of its claim).[4] In other cases a creditor's place in line is established notwithstanding the lack of the debtor's consent: the creditor can, following involvement of a court, get an "execution lien" or "garnishment" on the assets of the debtor.[5] Or, sometimes, a place in line may simply be given to a particular claimant by governmental fiat, in the form of a "statutory lien" or similar device.[6]

Although the *methods* for establishing a place in line are varied, the fundamental ordering principle is the same. Creditors are paid according to their place in line for particular assets. With a few exceptions, moreover, one's place in line is fixed by the time when one acquires an interest in the assets and takes the appropriate steps to publicize it.[7] A solvent debtor is like a show for which sufficient tickets are available to accom-

3. See generally Baird, "Notice Filing and the Problem of Ostensible Ownership," 12 *J. Legal Studies* 53 (1983).

4. In real estate this generally requires the recording of a deed of trust or mortgage with the applicable county recorder. With personal property, governed by Article 9 of the Uniform Commercial Code, it generally requires either the filing of a financing statement in the applicable office or offices or possession of the property by the secured party. See Uniform Commercial Code §§9-302 through 9-305; 9-401 (1978).

5. *Execution lien* generally refers to the lien that arises at or around the time the sheriff, following a judgment and the issuance of a writ of execution, seizes property. With respect to real property, the applicable lien is sometimes called a *judgment lien*, and it arises upon docketing of the judgment in the applicable files. With respect to many kinds of intangible personal property, such as an employer's obligation to pay wages to a debtor or a bank's obligation to pay money the debtor has on deposit with the bank, the applicable lien is called a *garnishment lien*, and it arises upon the serving of a writ of garnishment on the employer or bank, as the case may be. A brief survey of the details of creditor collection may be found in D. Baird & T. Jackson, *Cases, Problems, and Materials on Bankruptcy* ch. 1 (1985).

6. The most common label is *statutory lien*, although other terms (such as *statutory trust*) are commonly used. See Selby v. Ford Motor Co., 590 F.2d 642 (6th Cir. 1979). This point is discussed more fully in Chapter 4.

7. See, for example, the rules for New York, contained in N.Y. CPLR §§5202, 5203, 5232, 5234(b), 5236.

modate all prospective patrons and all seats are considered equally good. In that event one's place in line is largely a matter of indifference. But when there is not enough to go around to satisfy all claimants in full, this method of ordering will define winners and losers based principally on the time when one gets in line.

The question at the core of bankruptcy law is whether a *better* ordering system can be devised that would be worth the inevitable costs associated with implementing a new system. In the case of tickets to a popular rock event or opera, where there must be winners and losers, and putting aside price adjustments,[8] there may be no better way to allocate available seats than on a first-come, first-served basis. In the world of credit, however, there are powerful reasons to think that there *is* a superior way to allocate the assets of an insolvent debtor than first-come, first-served.

The basic problem that bankruptcy law is designed to handle, both as a normative matter and as a positive matter, is that the system of individual creditor remedies may be bad for the creditors *as a group* when there are not enough assets to go around. Because creditors have conflicting rights, there is a tendency in their debt-collection efforts to make a bad situation worse. Bankruptcy law responds to this problem. Debt-collection by means of individual creditor remedies produces a variant of a widespread problem. One way to characterize the problem is as a multiparty game—a type of "prisoner's dilemma."[9] As such, it has elements of what game theorists would describe as an *end period* game, where basic problems of cooperation are generally expected to lead to undesirable outcomes for the group of players as a whole.[10] Another

8. When a show is oversubscribed at a given price, and barring effective scalping laws, people who are first in line can resell the tickets at the market-clearing price. An upward price adjustment by the promoter in the ticket price may simply allow him (rather than those in line) to collect the difference. Although price adjustments arguably are superior to standing in line as a way of allocating tickets to a show, it is a solution that we can safely put aside for our purposes. The ultimate aim of creditor collection devices is collection of money. At the time of collection (as opposed to when the money is loaned, when it may make sense to take a lower interest rate in exchange for security—a place at the front of the line), paying money to improve one's place in line is simply a pointless swap of money for money.

9. A "prisoner's dilemma" rests (as does a common pool problem) on three essential premises. One, that the participants are unable (for one reason or another) to get together and make a collective decision. Two, that the participants are selfish (or cold and calculating) and not altruistic. Three, that the result reached by individual action is worse than a cooperative solution. See A. Rapoport & A. Chammah, *Prisoner's Dilemma* (1965).

10. When one expects that the game will be played an infinite number of times, cooperation may be the best strategy—which contradicts one of the premises necessary to

way of considering it is as a species of what is called a *common pool* problem, which is well known to lawyers in other fields, such as oil and gas.[11]

This role of bankruptcy law is largely unquestioned. But because this role carries limits on what *else* bankruptcy law can do, it is worth considering the basics of the problem so that we understand its essential features before examining whether and why credit may present that problem. The vehicle will be a typical, albeit simple, common pool example. Imagine that you own a lake. There are fish in the lake. You are the only one who has the right to fish in that lake, and no one constrains your decision as to how much fishing to do. You have it in your power to catch all the fish this year and sell them for, say, \$100,000.[12] If you did that, however, there would be no fish in the lake next year. It might be better for you—you might maximize your total return from fishing—if you caught and sold some fish this year but left other fish in the lake so that they could multiply and you would have fish in subsequent years. Assume that, by taking this approach, you could earn (adjusting for inflation) \$50,000 each year. Having this outcome is like having a perpetual annuity paying \$50,000 a year. It has a present value of perhaps \$500,000. Since (obviously, I hope) when all other things are equal, \$500,000 is better than \$100,000, you, as sole owner, would limit your fishing this year unless some other factor influenced you.[13]

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create a prisoner's dilemma. See R. Axelrod, *The Evolution of Cooperation* (1984); Hirshleifer, "Evolutionary Models in Economics and Law: Cooperation Versus Conflict Strategies," in 4 *Research in Law and Economics* 1 (1982). This is not true, however, when the number of times the game will be played has a known finite horizon. It then takes on the attributes of an end period game, where the dominant strategy is selfish behavior. See R. Axelrod, supra. Although insolvency may signal an end to relationships with one debtor, many creditors will still favor cooperation because of repeat dealings with each other. But not all will expect such repeat dealings, and destructive races to assets can be caused by a few "bad apples." I analyzed bankruptcy as a prisoner's dilemma in Jackson, "Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain," 91 *Yale L.J.* 857 (1982).

11. See Hardin, "The Tragedy of the Commons," 162 *Science* 1243 (1968); Libecap & Wiggins, "Contractual Responses to the Common Pool: Prorationing Crude Oil Production," 74 *Am. Econ. Rev.* 87 (1984); Friedman, "The Economics of the Common Pool: Property Rights in Exhaustible Resources," 18 *UCLA L. Rev.* 855 (1971).

12. This discussion assumes no costs—or, more precisely, nets them out; nothing in the example, however, turns on that. It also assumes that you are interested in fish only for the money they bring you; as we will see later, nothing really turns on that assumption either.

13. These other factors are likely to be few in number. If you thought you would die next year, you could still transmit your fishing rights to your children or sell them for \$500,000, buying \$100,000 of fish from other sources, and giving \$400,000 to some other charity. Only if you (and anyone who might buy your rights) were convinced that the

But what if you are not the only one who can fish in this lake? What if a hundred people can do so? The optimal solution has not changed: it would be preferable to leave some fish in the lake to multiply because doing so has a present value of $500,000. But in this case, unlike that where you have to control only yourself, an obstacle exists in achieving that result. If there are a hundred fishermen, you cannot be sure, by limiting *your* fishing, that there will be any more fish next year, unless you can also control the others. You may, then, have an incentive to catch as many fish as you can today because maximizing your take this year (catching, on average, $1,000 worth of fish) is better for you than holding off (catching, say, only $500 worth of fish this year) while others scramble and deplete the stock entirely.[14] If you hold off, your aggregate return is only $500, since nothing will be left for next year or the year after. But that sort of reasoning by each of the hundred fishermen will mean that the stock of fish will be gone by the end of the first season. The fishermen will split $100,000 this year, but there will be no fish—and no money—in future years. Self-interest results in their splitting $100,000, not $500,000.

What is required is some rule that will make all hundred fishermen act as a sole owner would. That is where bankruptcy law enters the picture in a world not of fish but of credit. The grab rules of nonbankruptcy law and their allocation of assets on the basis of first-come, first-served create an incentive on the part of the individual creditors, when they sense that a debtor may have more liabilities than assets, to get in line today (by, for example, getting a sheriff to execute on the debtor's equipment), because if they do not, they run the risk of getting nothing. This decision by numerous individual creditors, however, may be the wrong decision for the creditors as a group. Even though the debtor is insolvent, they might be better off if they held the assets together. Bank-

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world would end next year or that the government would confiscate your rights next year without compensation might your optimal strategy be to catch all the fish you could this year. In calculating how much fishing to do this year, you would need to weigh numerous factors and would undoubtedly face a number of uncertainties. You would, for example, be estimating reproduction and death rates of the fish, the likelihood of factors such as acid rain affecting future crops of fish, and the like. Thus, in assessing how much to fish, you would face a probability distribution, and one with some degree of uncertainty. You would also face a problem of controlling yourself once you made this decision. None of this, however, undercuts the point in text: you would try to take the course that you thought would bring you the greatest return, in present value terms.

14. Note that this, like the prisoner's dilemma, assumes that you are selfish, not altruistic. Where there are a hundred fishermen, it only takes one selfish one to upset the altruism of the others. Thus, the assumption seems quite reasonable.

ruptcy provides a way to make these diverse individuals act as one, by imposing a *collective* and *compulsory* proceeding on them. Unlike a typical common pool solution, however, the compulsory solution of bankruptcy law does not apply in all places at all times. Instead, it runs parallel with a system of individual debt-collection rules and is available to supplant them when and if needed.

This is the historically recognized purpose of bankruptcy law and perhaps is none too controversial in itself. Because more controversial limits on bankruptcy policy derive from it, however, less allegorical and more precise analysis is necessary. Exactly *how* does bankruptcy law make creditors as a group better off? To find the answer to that question, consider a simple hypothetical example involving credit, not fish. Debtor has a small printing business. Potential creditors estimate that there is a 20 percent chance that Debtor (who is virtuous and will not misbehave) will become insolvent through bad luck, general economic downturn, or whatever. (By insolvency, I mean a condition whereby Debtor will not have enough assets to satisfy his creditors.[15]) At the point of insolvency—I shall make this very simple—the business is expected to be worth $50,000 if sold piecemeal. Creditors also know that each of them will have to spend $1,000 in pursuit of their individual collection efforts should Debtor become insolvent and fail to repay them. Under these circumstances Debtor borrows $25,000 from each of four creditors, Creditors 1 through 4. Because these creditors know that there is this 20 percent chance, they can account for it—and the associated collection costs—in the interest rate they charge Debtor. Assume that each party can watch out for its own interest, and let us see whether, as in the example of fishing, there are reasons to think that these people would favor a set of restrictions on their own behaior (apart from paternalism or other similar considerations).

Given that these creditors can watch out for their own interests, the question to be addressed is *how* these creditors should go about protecting themselves. If the creditors have to protect themselves by means of a costly and inefficient system, Debtor is going to have to pay more to obtain credit.[16] Thus, when we consider them all together—Creditors 1

15. This is, by the way, almost precisely the definition of insolvency in the Bankruptcy Code. Section 101(29) defines insolvent as "with reference to an entity other than a partnership, financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation, exclusive of—(i) property tranferred, concealed, or removed with intent to hinder, delay, or defraud such entity's creditors; and (ii) property that may be exempted from property of the estate under section 522 of this title."

16. The extent to which this adjustment will result in the costs being fully transferred

through 4 *and* Debtor—the relevant question is: would the availability of a bankruptcy system reduce the costs of credit?

This requires us to try to identify what bankruptcy's advantages might plausibly be. Identification of abstract advantages is not, however, the end of the issue. One must also compare those possible advantages with the costs of having a bankruptcy system. Determining whether a bankruptcy system would reduce the cost of credit requires a net assessment of charges.

But first the case for bankruptcy's advantages. The common pool example of fish in a lake suggests that one of the advantages to a collective system is a larger aggregate pie. Does that advantage exist in the case of credit? When dealing with businesses, the answer, at least some of the time, would seem to be "yes." The use of individual creditor remedies may lead to a piecemeal dismantling of a debtor's business by the untimely removal of necessary operating assets. To the extent that a nonpiecemeal collective process (whether in the form of a liquidation or reorganization) is likely to increase the aggregate value of the pool of assets, its substitution for individual remedies would be advantageous to the creditors as a group. This is derived from a commonplace notion: that a collection of assets is sometimes more valuable together than the same assets would be if spread to the winds. It is often referred to as the surplus of a going-concern value over a liquidation value.

Thus, the most obvious reason for a collective system of creditor collection is to make sure that creditors, in pursuing their individual remedies, do not actually decrease the aggregate value of the assets that will be used to repay them. In our example this situation would occur when a printing press, for example, could be sold to a third party for $20,000, leaving $30,000 of other assets, but the business as a unit could generate sufficient cash so as to have a value of more than $50,000.[17] As such it

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back to the debtor depends on the elasticities of supply of and demand for credit. See Meckling, "Financial Markets, Default, and Bankruptcy: The Role of the State," 41 *Law & Contemp. Probs.* 13 (Autumn 1977); Weston, "Some Economic Fundamentals for an Analysis of Bankruptcy," 41 *Law & Contemp. Probs.* 47 (Autumn 1977).

17. The reasons for this result are complex. The assumption is that the printing press is worth only $20,000 in the hands of a third party but more in the hands of Debtor. If this is so, however, one might think that the third party could then turn and sell the press to Debtor for more than $20,000 (making its value in the hands of the third party more than $20,000). Indeed, pursuing this path leaves one with the question of why there would have been a default in the first place. See Klein, Crawford, & Alchian, "Vertical Integration, Appropriate Rents, and the Competitive Contracting Process," 21 *J. L. & Econ.* 297, 298–299 (1978). Suffice it to say, for our purposes, that informational and transactional barriers are often sufficient to permit this discrepancy to exist.

is directly analogous to the case of the fish in the lake. Even in cases in which the assets should be sold and the business dismembered, the aggregate value of the assets may be increased by keeping groups of those assets together (the printing press with its custom dies, for example) to be sold as discrete units.

This advantage, however, is not the only one to be derived from a collective system for creditors. Consider what the creditors would get if there were no bankruptcy system (putting aside the ultimate collection costs). Without a collective system all of the creditors in our example know that in the case of Debtor's insolvency the first two creditors to get to (and through) the courthouse (or to Debtor, to persuade Debtor to pay voluntarily), will get $25,000, leaving nothing for the third and fourth. And unless the creditors think that one of them is systematically faster (or friendlier with Debtor), this leaves them with a 50 percent chance of gaining $25,000, and a 50 percent chance of getting nothing.[18] A collective system, however, would ensure that they would each get $12,500.

Would the creditors agree in advance to a system that, in the event of Debtor's insolvency, guaranteed them $12,500, in lieu of a system that gave them a 50 percent chance of $25,000—payment in full—and a 50 percent chance of nothing? Resolution of this question really turns on whether the creditors are better off with the one than the other. There are two reasons to think that they are, even without looking to the question of a going-concern surplus and without considering the costs of an individual collection system. First of all, if these creditors are risk averse, assurance of receiving $12,500 is better than a 50 percent chance of $25,000 and a 50 percent chance of nothing. Even if they can diversify the risk—by lending money to many people—it is probably preferable to eliminate it in the first place.[19] This, then, represents a net advantage to having a collective proceeding.

18. These assumptions may not matter to the actual conclusion. Because of the "race," many of the special advantages one creditor holds may be worthless. Participation in or monitoring against the race will be costly for *all* creditors. In any event there will be residual elements of uncertainty of relative rankings that could be eliminated to the benefit of all creditors. Finally, there would be distinct advantages to a legal rule that presumed equality in the position of all creditors with similar legal entitlements, instead of delving into a case-by-case examination of factors such as "knowledge" or "friendliness." See Chapter 2.

19. Not all creditors, moreover, can achieve the requisite degree of diversification in a cost-effective way. The amount of diversification required to minimize the uncertainty cost may be quite large. See Langbein & Posner, "Market Funds and Trust Investment Law," 1976 *Am. B. Found. Research J.* 1.

One other possible advantage of a collective proceeding should also be noted: there may be costs to the individualized approach to collecting (in addition to the $1,000 collection costs).[20] For example, since each creditor knows that it must "beat out" the others if it wants to be paid in full, it will spend time monitoring Debtor and the other creditors—perhaps frequently checking the courthouse records—to make sure that it will be no worse than second in the race (and therefore still be paid in full). Although some of these activities may be beneficial, many may not be; they will simply be costs of racing against other creditors, and they will cancel each other out. It is like running on a treadmill: you expend a lot of energy but get nowhere. If every creditor is doing this, each one *still* does not know if there is more than a fifty-fifty chance that it will get paid in full. But in one sense, unless the creditors can negotiate a deal with each other, the creditors have no choice. Each creditor has to spend this money just to stay in the race because if it does not, it is a virtual certainty that the others will beat it to the payment punch. Of course, a creditor could decide that it did not want to stay in the race, and just charge Debtor at the time of lending the money for coming in last should Debtor become insolvent. Debtor is not likely, however, to agree to pay a creditor that extra charge for having a lower priority provision, because, once paid that extra amount, the creditor may have an incentive to take steps to remain in the race and make money that way.[21] For that reason it may be hard for a creditor to opt out of the race and get compensated for doing so.

These various costs to using an individual system of creditor remedies suggest that there are, indeed, occasions when a collective system of debt-collection law might be preferable. Bankruptcy provides that system. The single most fruitful way to think about bankruptcy is to see it as ameliorating a common pool problem created by a system of individual

20. The costs of individual creditor remedies, as posited in the example, is $4,000 for the creditors (and presumably some additional costs for the debtor). Bankruptcy costs may (but need not necessarily) be less. The most likely case for cost savings would be where the creditors would attempt to collect their claims at roughly the same time, as one would expect to occur when it was learned that Debtor was insolvent. A single inquiry into recurring collection questions is likely to be less expensive (both for the creditors and for the debtor) than the multiple inquiries necessary in an individualistic remedies system. See Weistart, "The Costs of Bankruptcy," 41 *Law & Contemp. Probs.* 107 (Autumn 1977). Other costs to the bankruptcy process are examined in Chapter 8.

21. The creditor could covenant to subordinate this loan, and the others might be viewed as third-party beneficiaries of that contract, thereby making it enforceable. But the solution has costs of its own, unless the creditor can control Debtor's intake of credit.

creditor remedies. Bankruptcy provides a way to override the creditors' pursuit of their own remedies and to make them work together.[22]

This approach immediately suggests several features of bankruptcy law. First, such a law must usurp individual creditor remedies in order to make the claimants act in an altruistic and cooperative way. Thus, the proceeding is inherently *collective*. Moreover, this system works only if all the creditors are bound to it. To allow a debtor to contract with a creditor to avoid participating in the bankruptcy proceeding would destroy the advantages of a collective system. So the proceeding must be *compulsory* as well. But unlike common pool solutions in oil and gas or fishing, it is not the exclusive system for dividing up assets. It, instead, supplants an existing system of individual creditor remedies, and as we shall see, it is this feature that makes crucial an awareness of its limitations.

Note that the presence of a bankruptcy system does not mandate its use whenever there is a common pool problem. Bankruptcy law stipulates a minimum set of entitlements for claimants. That, in turn, permits them to "bargain in the shadow of the law" and to implement a consensual collective proceeding outside of the bankruptcy process.[23] Because use of the bankruptcy process has costs of its own (as we shall see in Chapter 8), if creditors can consensually gain the sorts of advantages of acting collectively that bankruptcy brings, they could avoid those costs. Accordingly, one would expect that consensual deals among creditors outside the bankruptcy process would often be attempted first. The formal bankruptcy process would presumably be used only when individual advantage-taking in the setting of multiparty negotiations made a consensual deal too costly to strike—which may, however, occur frequently as the number of creditors increases.

These problems with optimal uses of bankruptcy are the subject of Chapter 8. It is possible that the rules specifying when a bankruptcy

22. As such, it reflects the kind of contract that creditors would agree to if they were able to negotiate with each other before extending credit. This is an application of the famous Rawlsian notion of bargaining in the "original position" behind a "veil of ignorance." See J. Rawls, *A Theory of Justice* 136–42 (1971).

23. See Mnookin & Kornhauser, "Bargaining in the Shadow of the Law: The Case of Divorce," 88 *Yale L.J.* 950 (1979). Nonbankruptcy "workouts" are in fact commonly observed. See "The Business in Trouble—A Workout without Bankruptcy," 39 *Bus. Law.* 1041 (1984); Coogan, Broude, & Glatt, "Comments on Some Reorganization Provisions of the Pending Bankruptcy Bills," 30 *Bus. Law.* 1149, 1154–60 (1975); Krause, "Insolvent Debtor Adjustments under Relevant State Court Statutes as against Proceedings under the Bankruptcy Act," 12 *Bus. Law.* 184, 185 (1957).

petition may be filed prevent the commencement of a collective proceeding until it is too late to save the debtor's assets from the self-interested actions of various creditors. Another possibility, however, is that the collective proceeding will begin too soon. Forcing all the creditors to refrain from individual actions (many of which have the effect of monitoring the debtor and preventing it from misbehaving) brings its own costs. Thus, to say that bankruptcy is designed to solve a common pool problem is not to tell us how to design the rules that do that well. These concerns do not, however, undermine the basic insight of what bankruptcy law is all about.

Like all justifications, moreover, this one is subject to a number of qualifications. To say that a common pool problem exists is not to say that individual behavior is entirely self-interested or that legal rules can solve all collective action problems. We often observe people behaving in a cooperative fashion over time even if it appears contrary to their short-run interest.[24] In the credit world, for example, creditors do not always rush to seize a debtor's assets whenever it seems to be in financial trouble. Yet despite this qualification the underlying point remains: sometimes people behave in a self-interested way and would be better off as a group if required to work together. The tragedy of the Texas oil fields in the first half of this century is a notable example of how self-interest led to the depletion of oil that otherwise could have been enjoyed by the group of oil field owners.[25] Creditor relations almost certainly are another area where this essential truth has validity, especially given the fact that creditors may have fewer incentives to cooperate when a debtor is failing than they do when there are greater prospects of repeat dealings with a debtor.

Nor can we be confident that the bankruptcy rules themselves do not create problems. They do, and we will examine later how they should be dealt with. Because these complications play out against a backdrop of basic bankruptcy principles, however, it is preferable for now to make two simplifying assumptions. The first assumption is that insolvency occurs without warning. By this assumption, we eliminate consideration of strategic behavior that is likely to exist when some creditors sense the imminent likelihood of bankruptcy's collective proceeding and attempt to avoid it. This assumption will be relaxed in Chapter 6. The second assumption is that bankruptcy proceedings take no time. By this assumption, we can set aside problems that occur through the passage of

24. Some of the reasons for this are explored in R. Axelrod, supra note 10.

25. See D. Glasner, *Politics, Prices and Petroleum* 32, 143–43 (1985); S. McDonald, *Petroleum Conservation in the United States: an Economic Analysis* 31–42 (1971).

time and the fact that this passage of time affects various claimants in different ways. We can also set aside the complications that result from a debtor's need to encourage people to deal with it while in bankruptcy and the fact that some of these people may wear both prepetition and postpetition hats. This assumption will be relaxed in Chapter 7.

Although imposing these two assumptions is, of course, somewhat unrealistic, doing so clarifies several key features of bankruptcy law. We can later extend our examination by making the inquiry somewhat more realistic. For now, however, it is sufficient to ask whether there is in fact a common pool problem that cannot be solved by creditors contracting among themselves. If the number of creditors is sufficiently small and sufficiently determinate, it may be possible for them to negotiate a solution at the time of insolvency that would avoid many, if not most, of the costs of an individual remedies system,[26] even if they were not bargaining in the shadow of the law. But in cases in which there are large numbers of creditors or the creditors are not immediately known at a particular time (perhaps because they hold contingent or nonmanifested claims), the ability of the creditors to solve the problem of an individual remedies system by an actual agreement may be lost. Bankruptcy provides the desired result by making available a collective system after insolvency has occurred.[27] It is the implications of that view of bankruptcy law that we can now begin to explore.

26. See Hoffman & Spitzer, "Experimental Tests of the Coase Theorem with Large Bargaining Groups," 15 *J. Legal Studies* 149 (1986); Libecap & Wiggins, supra note 11.

27. Bankruptcy is not the only possible legal response. One might imagine a less intrusive one to be a system whereby a debtor could decide whether to agree to allow its assets to be subject to a collective remedies system (such as bankruptcy law) by choice, made public by a nonretractable public filing. If such an election were virtually universal, a legal system such as our current bankruptcy law might be easier to administer.

is why the clause was written in the first place as a specific performance clause instead of a damages clause. But as we have already seen, the fact that a clause is cast as a specific performance clause is not itself sufficient to justify respecting it in full, because the issue is not one of the rights of the debtor versus the reversionary owner, but, now, the rights of third parties of the debtor versus the reversionary owner. And there the conversion of a specific performance right into a secured damages claim may be entirely proper.

To this point the discussion has been aimed at the anti–ipso facto clause directive of section 541(c)(1)(B). What of section 541(c)(1)(A), which provides that assets become property of the estate notwithstanding restrictions on transfer? As we have seen in discussing unusual rights such as letter of credit draws or waivers of a corporate attorney-client privilege, this provision has a logical reading—one that is fully consistent with the debt-collection role of bankruptcy: that assets become property of the estate but are fully subject to their nonbankruptcy attributes.

Consider a provision banning assignment of an asset. As we have seen, that is the essense of an asset such as a letter of credit, where the right to draw is not assignable as a matter of law. Notwithstanding that, however, the letter of credit becomes property of the estate, and the trustee succeeds to the right to draw if new management of the debtor could have succeeded to the draw outside of bankruptcy. To say this, however, is not to say much—only that a draw by the trustee has no more the attributes of an assignment than does a draw by new management outside of bankruptcy. The letter of credit remains subject to its terms. Thus, in *Swift Aire* the right to draw may have had no value to Swift Aire, which was liquidating, because of a requirement that it could be drawn on only for the continuing operations of the airline.

Moreover, section 541(c)(1)(A) speaks not at all to the question of whether it is possible to assign the asset to another party. That is a nonbankruptcy attribute that may restrict its value, because it may permit the asset to be used as long as the debtor remains in operation but will not permit the asset to be sold to another if it has no further use for it. This result, which applies to things from FAA landing rights to tax-loss carryforwards, simply follows again from the basic notion of bankruptcy as one implementing, in a collective forum, a series of rights (or their values) in existence outside of bankruptcy. Thus, when nonbankruptcy law draws a distinction between the use of an asset by the debtor, albeit with new owners or managers, and the use of an asset by a different entity, bankruptcy law can and should respect that distinction. Section 541(c)(1)(A) implements that distinction and, properly characterized, has no further role.

5

Executory Contracts in Bankruptcy: The Combination of Assets and Liabilities

HAVING EXAMINED liabilities and then assets, we are now ready to turn to the subject of executory contracts in bankruptcy. An executory contract, although not defined by the Bankruptcy Code, is generally considered for purposes of bankruptcy to be a contract on which performance remains due, to some material extent, on the part of *both* contracting parties, so that failure of either side to fulfill its remaining performance obligations would constitute a breach, justifying the failure of the other party to complete *its* unperformed obligations under the contract. The classic definition of executory contracts for purposes of bankruptcy was that given by Vern Countryman: "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other."[1] This seems to be the definition generally, although by no means exclusively, used in bankruptcy law.[2] However defined, executory contracts are the subject of a special section in the Bankruptcy Code, section 365, and a series of special rules.

Executory contracts, however, have few unique elements for purposes of bankruptcy analysis. Indeed, much of the difficulty caused by executory contracts arises out of the failure to perceive the relationship between assets and the liabilities in bankruptcy and how they interact in

1. Countryman, "Executory Contracts in Bankruptcy (pt. 1)," 57 *Minn. L. Rev.* 439, 460 (1973).

2. See H. Rep. No. 595, 95th Cong., 1st Sess. 347 (1977); Jensen v. Continental Finance Corp., 591 F.2d 477, 481 (8th Cir. 1979). For other definitions, see concluding pages of this chapter. Section 365 deals also with "unexpired leases." I shall include them in the term *executory contract*.

the case of executory contracts. Fundamentally, executory contracts, as Countryman has defined them and as the Bankruptcy Code seems to intend, are nothing more than mixed assets and liabilities arising out of the same transaction.[3] This can be seen by considering a simple example. Say Debtor, on December 1, entered into a contract with Supplier for Supplier to ship 1,000 pairs of pants on February 1, with payment by Debtor of $10,000 on April 1. From December 1 until February 1 the contract is executory because either side could breach its yet unperformed obligation, giving rise to a power of termination by the other side. Supplier could fail to deliver the pants, for example, in which case Debtor would be relieved of its obligation to pay $10,000. Conversely, Debtor could announce that it would not pay for the pants when delivered, and this "anticipatory repudiation" would relieve Supplier of its obligation to deliver the pants. Thus, up until February 1 this contract is both an asset of Debtor's (the right to receive 1,000 pairs of pants) and a liability (the obligation to pay $10,000).

This mixture of an unperformed asset and a liability in the same contract is the special attribute of an executory contract. But after February 1, if Supplier meets its obligation to deliver conforming pants, the contract is no longer executory. This is so, because once the nonbankrupt party has fully performed, the issue is only one of a liability of the debtor—a claim. In our example, following delivery of 1,000 pairs of conforming pants on February 1, Debtor becomes owner of the pants, and Supplier (unless it took a security interest or can rely on the limited protections of section 2-702 of the Uniform Commercial Code[4]) becomes an unsecured creditor of Debtor. Supplier's claim is, at that time, analytically no different from claims arising out of simple loan transactions where Debtor has not repaid borrowed money. Since it is nothing more than a claim, there is no point in talking about "assumption" or "rejection" of the contract in terms different from those we analyzed in Chapter 2.

3. Countryman recognized at least half this truth. See Bordewieck & Countryman, "The Rejection of Collective Bargaining Agreements by Chapter 11 Debtors," 57 *Am. Bankr. L. Rev.* 293, 303 (1983) ("Were it not for §365, all contracts and leases in which the debtor had a legal or equitable prepetition interest would become property of the estate under §541(a)(1). Perhaps §365 should be viewed as a limitation on §541(a)(1) giving the debtor . . . an option to decide whether executory contracts and unexpired leases should become property of the estate").

4. Uniform Commercial Code §2-702(2) (1978), provides: "Where the seller discovers that the buyer has received goods on credit while insolvent he may reclaim the goods upon demand made within ten days after the receipt, but if mispresentation of solvency has been made to the particular seller in writing within three months before delivery the ten day limitation does not apply." With some changes (which, under the analysis of this book, are questionable) the Bankruptcy Code respects this right, §546.

If, however, the debtor has performed fully, then the contract is not executory for precisely the opposite reason. Since the debtor only has to await a return performance by the other party, the contract is an asset of the estate. In our example, if Debtor prepaid for the pants on February 1, with delivery scheduled for April 1, then once payment was made, Debtor has a right to receive the pants that is no longer contingent on performance by Debtor. That right is property of the estate. It makes no more sense to talk about the Debtor's choice between "assumption" and "rejection" of this contract right than it does about such a choice with respect to other assets. Accordingly, the framework for analyzing this issue would be that of assets as discussed in Chapter 4.

Contracts, however, that remain to be performed to a substantial extent by both parties—such as our hypothetical contract prior to February 1—bear attributes both of assets and of liabilities. The debtor's unperformed obligations are liabilities from the perspective of the debtor's other claimants, while the nonbankrupt party's unperformed obligations are an asset from their perspective. The question of how to treat these mixed contracts in bankruptcy would have been aided if bankruptcy law had traced out the consequences of recognizing any such contract as *both* an asset and a liability. Such an analysis would take the form of that used to resolve cases such as *Chicago Board of Trade*[5] where an asset was coupled to a particular liability. In such cases one determines relative values and the residual value of the asset concurrently. This is accomplished by netting out the difference between the asset and the liability, and the holder of the liability is given a superior claim to the extent of the value of the asset. There is conceptually no reason to treat executory contracts any differently.

In *Chicago Board of Trade*, for example, the debtor held an asset (membership in the Board of Trade) that could be sold for, say, \$10,000. But because of the rules of the Board of Trade, it could not be sold without first paying off membership debts. If there were \$6,000 of such debts, the net value of the asset would have been \$4,000 to the debtor's other claimants. If, however, there were \$15,000 of such debts, the membership liabilities would exceed the value of the asset, and there would be no residual value to the other claimants. There is no reason to reach a different result simply because one characterizes the membership as an executory contract.

This principle, of course, may be extended. For example, a lease that has one year to run at a rental of \$10,000 may or may not be valuable to the other claimants, depending on the value of the leased space to

5. 264 U.S. 1 (1924). See supra Chapter 4.

the debtor. If, however, the lessor has the right to terminate the lease under nonbankruptcy law, then *Chicago Board of Trade* would suggest that the value of the lease to the debtor's other claimants would be net of the liability to the landlord—which, in this case, may be a residual of zero.

Rejection and the Nonbankruptcy Attributes of Breach

Understanding this simple relation between assets and liabilities would remove much of the current obscurity in bankruptcy law surrounding executory contracts. Much case law and existing analysis relating to whether a contract is executory create unnecessary work when the question is one of rejection.[6] Apart from contracts that effectively give the holder a right of specific performance, rejection is simply tantamount to a breach of the contract permitted under nonbankruptcy law. Under applicable nonbankruptcy law a breach generally gives rise to a monetary claim for damages. Thus, if Debtor had a contract with Creditor to buy 1,000 bushels of wheat for $4 a bushel and the price of wheat falls to $3 a bushel, Debtor, whether or not it is in bankruptcy, can "reject" the contract and purchase wheat elsewhere for $3 a bushel. If Debtor is solvent, this path does not sound particularly promising, for Debtor's gain from this breach ($1,000) would seem to be matched by Creditor's $1,000 damage claim.[7] But if Debtor is insolvent, a breach in bankruptcy is sensible from the perspective of the creditors as a group, at least as long as Creditor does not have an effective security interest in $1,000 or more of Debtor's assets. By not performing the contract, Debtor saves $1,000. Creditor, to be sure, holds a $1,000 claim, but assuming that claim is unsecured, it will not be paid in full. Thus, some portion of the $1,000 saved by rejection is available for Debtor's other unsecured creditors.

This appears at first glance to be simply a wealth transfer from Creditor to Debtor's other general creditors, with no effect on the group as a whole. Permitting the rejection nonetheless is proper in bankruptcy, because of the notion of relative values. Creditor is just like the other unsecured creditors: a party with a nominal claim that, because Debtor is insolvent, will not have its expectancies met in full. There is no reason

6. See, e.g., *In re* Chicago, R.I. & P. RR Co., 604 F.2d 1002 (7th Cir. 1979); *In re* Oxford Royal Mushroom Products, Inc., 45 Bankr. 792 (Bankr. E.D. Pa. 1985); cf. Nimmer, "Executory Contracts in Bankruptcy: Protecting the Fundamental Terms of the Bargain," 54 *U. Colo. L. Rev.* 507, 513 (1983).

7. See, e.g., A. Farnsworth, *Contracts* 838–48 (1982).

Creditor should have its claim paid in full (by required adherence to the contract) when all other unsecured creditors are getting only a few cents on the dollar. Rejection, then, provides a way of *equalizing* things among creditors when the liability represented by the contract exceeds the value of the asset represented by a contract.

The same situation would result in the absence of a special executory contract section with an explicit power to reject. As we saw in Chapter 2, when a debtor borrows money, its obligation to repay is (or can be) breached when the debtor goes into bankruptcy. Nothing more is at stake in the rejection of most contracts in bankruptcy. For that reason, when the issue is one of rejection of an ordinary contract, it makes no difference whether the contract is executory (in which case rejection gives rise to a claim for damages) or nonexecutory (in which case the debtor's obligations—such as loan payment—are breached either because the debtor is liquidating or because the debtor decides to place the lender in the pool of creditors by anticipatorily declaring nonrepayment in full, in which case it also gives rise to a claim for damages).

Here, as before, however, the ability to reject should depend on nonbankruptcy attributes. It was earlier noted that normal rules of contractual specific performance—such as arise when Debtor contracts to sell its Chagall to Buyer for $10,000—when analyzed as a question of rights among creditors, do not require that the specific performance right should be respected in kind. In those cases, because lien creditors outside of bankruptcy could trump the holder of the specific performance right who left the property with the debtor, neither the specific performance right nor its value should be respected in full in bankruptcy. There is no reason a different conclusion would follow simply because the contract is executory.[8]

Sometimes, however, analysis of the applicable nonbankruptcy attributes suggests that specific performance would apply even when analyzing the issue as one of relative rankings among creditors. Consider the following. Debtor owns Blackacre and has leased it to Lessee.[9] Under applicable nonbankruptcy law, even when Debtor breaches its obligations

8. For example, Buyer may have prepaid $9,000 of the $10,000 contract price for the Chagall, instead of (as assumed supra Chapter 2) the entire $10,000.

9. This example is loosely based on *In re* Minges, 602 F.2d 38 (2d Cir. 1979). In *Minges* there was a secured lender with a security interest in Blackacre. The court saw rejection as proper only if it would benefit the general creditors instead of simply constituting a wealth transfer between the secured lender and the lessee. But since the secured lender has agreed to be subordinate to the rights of the lessee, the proper normative justification would have been that, since the lessee took precedence over the secured lender outside of bankruptcy, their relative positions should not be reversed in bankruptcy.

under the lease, Lessee (because it has a possessory property interest in Blackacre) cannot be deprived of its possession without its consent.[10] This right, moreover, because it is possessory, is effective against creditors of Debtor.[11] To the extent that this is so, Debtor should not be able to regain possession of Blackacre, over Lessee's objection, by rejecting the lease in bankruptcy. Section 365(h) provides for this result, but it should not depend on finding a special safe-harbor in the Bankruptcy Code. For example, if Debtor leases not Blackacre, but Green Machine—an item of personal property—to Lessee, as long as nonbankruptcy law provides for the same result in the case of an attempted breach of the lease by Debtor (that Lessee has the right to continue in possession), and if this result is also effective against creditors of Debtor (as is probably the case when Lessee is in possession), section 365 should not be construed to provide a different result on rejection in bankruptcy.

The point of this discussion is twofold. First, in most cases the power to reject in section 365 should be viewed as no more than stating the obvious: that contracts can be breached, converting the other party into the holder of a damage claim (which may or may not be secured). Second, the nonbankruptcy limitations of the power to reject must also be recognized. Many nonbankruptcy rights, although created pursuant to a contract, take on a life of their own once created and become effective not only against the debtor but also against others (such as creditors) claiming through the debtor. Nothing in bankruptcy's collectivization principle calls for a different allocative outcome in bankruptcy.

Many of the most troublesome problems created by automatic application of the ability to reject contracts in bankruptcy could have been avoided had this simple relation between bankruptcy law and nonbankruptcy attributes been kept in mind. For example, consider a license agreement where Debtor is the licensor, having licensed Manufacturer with the exclusive right to use a computer chip technology upon payment of an initial license fee of $100,000, and thereafter at the rate of ten cents per chip used. This is probably an executory contract, because both Debtor and Manufacturer have continuing duties to the other.[12] But

10. "A lease is partly the conveyance of an estate, which is deemed fully executed once the tenant takes possession. Therefore the weight of authority is that the conveyance aspect of a lease may not ordinarily be unilaterally disturbed by a debtor landlord or his trustee." *In re* Minges, 602 F.2d 38, 41 (2d Cir. 1979).

11. Cf. McCannon v. Marston, 679 F.2d. 13 (3d Cir. 1982).

12. Manufacturer has the obligation to pay ten cents a chip; Debtor has (at least) the obligation not to license the technology to anyone else. See, e.g., Lubrizol Enterprises v. Richmond Metal Finishers, 756 F.2d 1043 (4th Cir. 1985), cert. denied, 106 S.Ct. 1285 (1986); *In re* Petur U.S.A. Instrument Co., 35 Bankr. 561 (Bankr. W.D. Wash. 1983); cf.

irrespective of its characterization, there is no reason to think that Debtor, in bankruptcy, should be able to reject the license agreement (as it would do if it wanted to license the technology to someone else or take advantage of a successful implementation of the technology by relicensing Manufacturer at a higher rate). No such outcome could occur outside of bankruptcy, as Manufacturer would have the right to enjoin Debtor from breaching the license agreement. Declaring the contract to be executory (instead of, say, an outright sale of the technology) should not create a different bankruptcy result because of the unthinking application of a right of rejection written into section 365. This is the kind of nonbankruptcy specific performance right that seems effective not only against Debtor but also against those that claim through Debtor, be they creditors, lien creditors, or purchasers. Accordingly, an examination of relative values suggests that rejection should not be permitted in bankruptcy.

Application of this point would have suggested a different outcome in the Supreme Court's decision in *National Labor Relations Board v. Bildisco & Bildisco*,[13] a case that dealt with whether collective bargaining agreements could be rejected in bankruptcy. At least as a normative matter[14] collective bargaining agreements may call for substantially different treatment in bankruptcy than do ordinary executory contracts because, on analysis, the value of the right provided employees by the National Labor Relations Act vis-à-vis other claimants may be much closer to that of an entity holding a full-fledged property (and priority) right. If so, there may be little point to an attempt to disregard the right, because the relative value of the right, properly understood, is far greater than that of an unsecured creditor. Rejection of the labor contract and treating the resulting claim as unsecured may respect neither the right nor its relative value.

Federal labor law determines when a new employer is bound by the terms of a collective bargaining agreement of the old employer.[15] Under

In re Rovine Corp., 6 Bankr. 661 (Bankr. W.D. Tenn. 1980) (franchise agreement with covenant not to compete).

13. 465 U.S. 513 (1984).

14. Section 365 may have carried with it so much baggage at that time that perhaps the fault was Congress's for not specifying distinctions. (This is more likely the case following Congress's enactment of §1113 in 1984. Although it conceivably could be construed as a rule designed to simplify, but mirror, nonbankruptcy NLRB rules, it is unlikely that such a rationale motivated the section.) The normative point is the same: there is no reason to grant a debtor a new substantive power over executory contracts.

15. National Labor Relations Act §§8(a)(5), 8(d), 29 U.S.C. §158(a)(5), (d) (1975); see N.L.R.B. v. Bildisco & Bildisco, 465 U.S. 513 (1984) ("the practical effect of the enforce-

the policies of the National Labor Relations Board, if a company that purchases the assets of another company bears few of the ownership or managerial attributes of the company whose assets were purchased, it is freed of the collective bargaining agreements of the purchased company.[16] Apart from this, however, the labor union has a right of specific performance with respect to the collective bargaining agreement. There is good reason to believe that the reasons for holding collective bargaining agreements enforceable against successor corporations so long as their assets are not splintered up or sold to a new entity are quite different from those at work in the context of an ordinary contract. The function of the labor law rule seems directed at *preferring* the protected group of union members by giving them a set of nonwaivable precedural rights effective both against the debtor and its other claimants.[17] In this context the workers' right to enforce a collective bargaining agreement except in cases of either a piecemeal liquidation or the sale of the business to a substantially new group of owners appears to take the form of a nonbankruptcy property (and priority) right.

If the analysis rightly captures the relevant considerations of nonbankruptcy law and policy, then bankruptcy law should mirror the rights established by labor law by enforcing them as they exist or by respecting their relative value. This would mean that the collective bargaining agreement could be rejected in a liquidation of the debtor, because permitting rejection in that context mirrors the nonbankruptcy attributes of labor law policy. But in a reorganization of the debtor the best nonbankruptcy analogue seems to be the continuation of the debtor, with new owners. To the extent that federal labor law does not permit disaffirmance of collective bargaining agreements in that context, there is

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ment action would be to require adherence to the terms of the collective bargaining agreement"); N.L.R.B. v. Lion Oil Co., 352 U.S. 282, 285 (1956).

16. See Howard Johnson Co. v. Detroit Local Joint Executive Board, 417 U.S. 249 (1974); N.L.R.B. v. Burns International Services, Inc., 406 U.S. 272, 281–91 (1972); Note, "The Bargaining Obligations of Successor Employers," 88 *Harv. L. Rev.* 759 (1975).

17. See, e.g., Allied Chemical Workers v. Pittsburgh Plate Glass Co., 404 U.S. 157 (1971); John Wiley & Sons, Inc. v. Livingston, 376 U.S. 543, 550 (1964); United Steelworkers v. Warrier & Gulf Navigation Co., 363 U.S. 574, 578–80 (1960); N.L.R.B. v. American Nat'l Insurance Co., 343 U.S. 395 (1951). This may be in contrast to damage claims (such as back pay awards) as distinct from bargaining rights, cf. Nathanson v. N.L.R.B., 344 U.S. 25, 28–29 (1952) ("The policy of the National Labor Relations Act is fully served by recognizing the claim for back pay as one to be paid from the estate"). Thus, the issue is one of recognizing applicable nonbankruptcy analogies, not, as is commonly perceived, one of "balancing" labor law policy with bankruptcy law. The balancing approach continues, however, to dominate analysis. See, e.g., George, "Collective Bargaining in Chapter 11 and Beyond," 95 *Yale L.J.* 300 (1985).

no reason to think that creditors (the new owners) should have that right in bankruptcy.

Other creditors consequently have an incentive to force the bankrupt entity into a piecemeal liquidation.[18] This risk, however, does not justify disregarding the relative value of the right because recognizing it does not make the situation *worse* in bankruptcy. Labor law is part of the warp and woof of the fabric that exists independently of bankruptcy. Its existence may make things worse for creditors as a group by requiring the actual consent of one particular group in order to override the right,[19] but its existence does not make things worse for creditors in a collective proceeding than outside it. There is, accordingly, no bankruptcy law policy to "balance" with labor law policy.

In all case there is no normative reason to apply the concept of rejection beyond its nonbankruptcy channels, where it is used to equalize the status of those claimants who outside of bankruptcy were equals. When it is used to substantively rearrange entitlements by equalizing those who are not nonbankruptcy equals, it is used improperly.

The General Rule and a Critique of Section 365(c) and (f)

The importance of understanding the nature of executory contracts is broader than the topic of rejection. Recognizing that all executory con-

18. Included in this attempt to mirror attributes is a determination whether the entity emerging out of bankruptcy satisfies the "new entity" tests of labor law described previously. That question demands that one assess the quantum of managerial and ownership changes that occurred in the bankruptcy process. See Blazer Industries, Inc., 236 N.L.R.B. 103, 109–10 (1978). This translation problem raises factual problems in the reorganization context (e.g., is the change in ownership substantial enough?), and it may engender some uncertainty in application if the issue arises before confirmation of a plan of reorganization. The relevant point, however, is that this is a factual question, not one of independent bankruptcy policy, where the distributional question is tied to the deployment question. Unlike with most cases, where the two inquiries should be kept distinct, here the skewing in the choice of deployment is a result of a nonbankruptcy tie between the two questions.

19. In theory, labor can be bought off by reallocating some of the going-concern value from the other creditors. Cf. Coase, "The Problem of Social Costs," 3 *J. Law & Econ.* 1 (1960); Brief for the National Labor Relations Board in N.L.R.B. v. Bildisco & Bildisco, at 23 ("if collective bargaining agreements are not set aside in bankruptcy, unions have an interest in agreeing to the modification of burdensome contract terms to prevent employers from going out of business, thereby preserving jobs for their members"). Realistically, the bargain may be unobtainable because of the number of parties involved or because the costs to the union of agreeing to a "lesser" bargaining agreement (e.g., the effect any such agreement may have on other collective bargaining agreements with other employers) may be greater than any associated benefit to this particular employer.

tracts raise the same type of inquiries as other claims or property cases—having mixed attributes of both assets and liabilities, subject to the special feature that the asset is coupled to the liability—has a number of implications for the proper shape and direction of the Bankruptcy Code. Some of these implications can be clarified by looking at executory contracts in the three contexts in which we examined liabilities in Chapter 2 and assets in Chapter 4. First, what should be the presumptive rule in bankruptcy for executory contracts not yet in default? Second, what should occur in bankruptcy in the case of a prebankruptcy default? Third, what effect should be given to contractual ipso facto clauses? Not surprisingly, answers to these questions spring naturally from the answers associated with assets and liabilities and provide a basis for a critical inquiry into section 365's special rules.

We have already seen that the general rules for treating assets and liabilities in bankruptcy are derived from a recognition of the attributes of the closest nonbankruptcy analogue. In the case of a liquidating corporate debtor, for example, the best analogy was that of a dissolving corporation under state law. Since a dissolving debtor ceases to exist, there are several nonbankruptcy consequences. In the case of liabilities, where the general contract rule is that there can be no delegation of performance if there is also a divesting of duties, the dissolution accordingly would presumptively constitute a default and acceleration of the liability. The discussion of assets followed the same approach: in the case of an asset that could be used by the debtor but not assigned (such as FAA landing rights),[20] the debtor's dissolution would mean that the asset had no value to the debtor's general creditors. Accordingly, although such an asset would properly be characterized as property of the estate, its nonbankruptcy attributes would give it a zero value in a bankruptcy liquidation.

The same analysis should be used to examine executory contracts. Because, definitionally, the debtor had an unperfomed obligation, the contractual bar on divestment of duties would preclude delegation of performance coupled with a divestment of duties. Accordingly, for a debtor liquidating in bankruptcy, unless the nonbankrupt party consented to an assignment, or unless the debtor could perform its obligation before liquidating, its executory contracts should be viewed as breached (anticipatorily) by the debtor, giving rise to a loss of the associated asset *and* the obligation to pay for it. What remains, of course, may be a claim

20. See *In re* Braniff, 700 F.2d 935 (5th Cir. 1983) for a discussion of the attributes of FAA landing rights.

for damages by the nonbankrupt party, if it has suffered damages. Like other liabilities, this damage claim would be unsecured, unless the nonbankrupt party had protected itself with a security interest or the state had protected it with a form of statutory lien (or the like).

This result flows from the structure of assets and liabilities in bankruptcy. As a result of the failure to understand the asset and liability in each executory contract, however, the current Bankruptcy Code has moved in a substantially different direction. A liquidating debtor can assume most executory contracts. Any contract it can assume, moreover, can be assigned pursuant to section 365(f). A debtor would do this, presumably, when its executory contract was favorable from its perspective. For example, Debtor might have a lease of office space from Lessor with five years to run at $20,000 (present value) a year. If the market rate for such leases is now $25,000 (present value) a year, Debtor's lease is a net asset (netting out the present value of the asset—$125,000—and the $100,000 liability) of $25,000. If Debtor breaches this lease, it gets nothing (no asset, but no damage claim either); Lessor gets the opportunity to re-let the space and thereby make $25,000 more. If Debtor, however, could assign this lease, it could obtain $25,000 for its unsecured creditors.

Apparently on the view that unsecured creditors get more if executory contracts can be assigned,[21] section 365 permits their assignment. This approach, however, ignores the principle of reflecting nonbankruptcy attributes in a collective regime. To use our example as an illustration, the fact that Debtor cannot use its lease (because it is liquidating) and cannot assign it under applicable nonbankruptcy law means, to be sure, that Lessor and not Debtor's general creditors gets the "extra" $25,000.[22] The question of relative ordering of claimants, however, because it is a distributional question and not a deployment question, is not a bankruptcy issue. Nothing in the collectivization norm calls for reallocating values in bankruptcy or giving any special breaks (other than those that

21. See, e.g., Silverstein, "Rejection of Executory Contracts in Bankruptcy and Reorganization," 31 *U. Chi. L. Rev.* 467, 468 (1964) (executory contract section designed to free the "estate to pay a larger dividend to general creditors"); Fogel, "Executory Contracts and Unexpired Leases in the Bankruptcy Code," 64 *Minn. L. Rev.* 341, 349 (1980).

22. Sometimes, as with the contract with Supplier for pairs of pants, even a liquidating Debtor could gain the advantages of a favorable contract by remaining in operation long enough to pay for the pants and then reselling them to a third party. In such a case assumption should be possible, even though Debtor is liquidating, because Debtor is able to complete the contract. Again, the ability vel non to assume comes from an examination of nonbankruptcy attributes, not per se from the use of bankruptcy or a decision to liquidate in bankruptcy.

follow from collectivization itself) to general creditors in bankruptcy.

Section 365(f) is not only incompatible with normal bankruptcy principles but also inconsistent with the treatment of liabilities in bankruptcy. To see why, recall that an unaccelerated below-market loan is also an asset from the debtor's perspective. If a debtor could sell an asset with such a loan, the asset could fetch more than if the asset were being sold without the below-market financing. Yet loans *are* accelerated in a bankruptcy liquidation (although not necessarily in a reorganization), precluding this option. Recognizing an executory contract as nothing more than an associated asset and liability reveals the inconsistency of permitting a liquidating debtor to assign below-market executory contracts.[23]

The rule of section 365(f) suffers from one more defect. It strikes down antiassignment clauses, instead requiring the assignee to give adequate assurance of future performance. These provisions require one to determine whether something is effectively an antiassignment clause (in which case it is ignored) or is effectively a term of the contract (in which case it must be adhered to). The problem is that no such line can be drawn with precision.[24] An antiassignment clause—such as "*A* cannot assign his obligation to deliver wheat to me"—can be redrafted, with considerable accuracy, to become a term of the contract—"*A* personally must deliver to me wheat *A* has grown on *A*'s farm, located in Blackacre, Kansas." These issues could be largely avoided, if section 365 recognized that the source of attributes should be nonbankruptcy law, not special bankruptcy policy.

To this point the focus has been on the proper treatment of executory contracts in the case of a liquidating debtor. What, however, of the case of a debtor that is reorganizing? Again, the previous discussion of assets and liabilities in bankruptcy can be drawn on. It seems presumptively proper to treat a reorganizing debtor as undergoing a transformation equivalent to a change of ownership of the debtor outside of bankruptcy.

23. For a numerical example showing the similarity of the loan and the executory contract, see Jackson, "Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain," 91 *Yale L.J.* 857, 883–85 (1982). In this respect the proposal of the Commission on Bankruptcy Laws was more consistent with bankruptcy principles. See Report of the Commission on Bankruptcy Laws of the United States, H.R. Doc. 137, 93rd Cong., 1st Sess., pt. 1 at 198 (1973) ("In a liquidation situation . . . the right of the nondebtor party to choose to deal only with the debtor, as provided by an anti-assignment or similar contractual clause, should be preserved").

24. See, e.g., *In re* U.L. Radio Corp., 19 Bankr. 537 (Bankr. S.D.N.Y. 1982) (clause restricting use to an "electronics store" is disregarded so lease could be assigned to a restaurant).

If a contract to deliver 1,000 pairs of pants to Debtor would survive a nonbankruptcy change of ownership of Debtor, it should be a contract that Debtor—or more precisely, its creditors—can use (or breach) in bankruptcy as well. It is in this context that the power of assumption makes the most sense.

This, however, is a right of a reorganizing debtor to use executory contracts whose net value is positive, and it derives from nonbankruptcy attributes. Similarly, our previous discussion of *assignments* of executory contracts can be reanalyzed in the case of a reorganizing debtor against relevant nonbankruptcy attributes, because if the reorganizing debtor has no use for the executory contract, nonbankruptcy attributes still govern assignment of it to a third party. Since the debtor, in a reorganization, remains in existence, it is possible to delegate duties without the debtor divesting itself of responsibilities. In these cases assumption and assignment *are* proper, but only to the extent permitted by nonbankruptcy law: if the contract contains an antiassignment clause that is effective under nonbankruptcy law, it is wrong to ignore it in bankruptcy, as section 365(f) does. Analysis of antiassignment clauses should spring from nonbankruptcy attributes.

The failure of the drafters of section 365 to appreciate the limited normative role of bankruptcy policy has led to a curious failure to differentiate between assumption and assignment. Section 365(c) and (f) prohibit the assumption or assignment of executory contracts where "applicable law excuses a party, other than the debtor . . . from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession or an assignee of such contract or lease," including explicitly contracts to make loans or to extend financial accommodations. This (once one resolves some linguistic ambiguities created by the 1984 amendments[25]) precludes assumption where "applicable law" prohibits assignment. This line is drawn at the wrong place. In the case of personal service contracts and the like—where applicable law prohibits assignment without consent—the point of the restriction is to ensure that the nonbankrupt party gets performance

25. The addition of the language "or an assignee," if read literally, may render the entire section superfluous; it apparently should be read to mean a *consensual* assignee. The addition of "or the debtor in possession" does not seem to cure the problem addressed in text. This section still would seem to prohibit assumption *by* the trustee or debtor in possession when applicable law refuses nonconsensual assignment to an entity *other than* the debtor or debtor in possession. Whether this garbled drafting will be used to reach the result that assumption is proper but assignment is not is an open question.

from precisely who it contracted with.[26] If Placido Domingo contracts to sing the role of Don Jose in "Carmen" at the Met, he cannot assign the contract to (say) me.

This, however, should not prevent a reorganizing debtor from *assuming* a contract, if applicable nonbankruptcy law does not treat a change in the ownership of the debtor as an assignment. Consider the case of FAA landing rights (as if they were executory contracts). In this case "applicable law" prohibits assignment. Yet if an airline is reorganizing in bankruptcy, the relevant nonbankruptcy question should be whether the FAA landing rights survive a change of ownership. Section 365(c), however, operates as a bar because that nonbankruptcy question is ignored. With personal service contracts (and the like) the line should be drawn at assignment, not necessarily at assumption.

Assumption Following Default and Ipso Facto Clauses

An examination of executory contracts in light of the remaining two questions—should executory contracts be assumable irrespective of default and should ipso facto clauses be respected—can now proceed quickly. No new twists are introduced by executory contracts in these contexts; the same analysis used in discussing assets and liabilities can be undertaken.

Consider the case of a prebankruptcy default. Section 365(b) permits assumption notwithstanding defaults as long as the defaults are cured or promptly will be cured. As we have seen, however, such a cure power sweeps too broadly because it is unrelated to the reasons for bankruptcy itself. A debtor who loses a valuable executory contract outside of bankruptcy because of a default presumptively should fare no better in bankruptcy either. The two exceptions to this occur when the debtor defaults either to favor the nonbankrupt party (by returning a valuable asset to it and allowing the party to remove itself from an impending collective proceeding) or because the debtor knows it is insolvent and simply no longer cares what happens to its assets. The first problem is properly analyzed (as the current Bankruptcy Code does not) as a species of preference law. The case of debtor passivity raises the same sorts of questions. These issues will be discussed in the next chapter. In these instances a limited reach-back rule may be proper. Even then section 365(b), which is unlimited in time, sweeps too broadly.

26. See, e.g., Restatement (Second) of Contracts §318, comment c (1981).

As for ipso facto clauses, we have seen that a presumptive rule barring their effectiveness may be justified for both assets and liabilities. Since an executory contract is best thought of as a mixed asset and liability, nothing, accordingly, should change. But it is important to note that, in the context of bankruptcy as a device to ameliorate a common pool problem, the effect of refusing to recognize ipso facto clauses would be far smaller than in the world of section 365. Substantial nonbankruptcy restrictions, which section 365 tosses aside in an unprincipled manner, should continue to operate. Under such a regime a liquidating debtor, for example, could not effectively assume many executory contracts nor (unless permitted by the contract) could it assign them because of application of the nonbankruptcy norm of no divestment of duties. A reorganizing debtor, moreover, could assume executory contracts, but antiassignment clauses, either in the contract itself or in applicable law, would continue to be recognized. Thus, nonrecognition of ipso facto clauses in bankruptcy would have a substantially smaller effect than currently is the case.

A Concluding Note on Section 365

Section 365, as we have seen, is substantially flawed when examined from the perspective of bankruptcy law as a debt-collection device. Its flaws stem from a failure to perceive the derivative nature of executory contracts from ordinary assets and liabilities, and consequently it disregards nonbankruptcy rights so as to benefit general creditors (and, correspondingly, harm some other claimant, usually the party on the other side of the contract). These changes are unfortunate in themselves, but equally unfortunate is the invitation such an inappropriate substantive rule extends for the manipulation of other concepts so as to similarly favor general creditors.

Consider, for example, *In re Booth.*[27] In *Booth* the court was faced with the question of whether a debtor, who was a vendee under a contract for deed, had an executory contract. The essential feature of a contract for deed is that the vendor retains title until the time the vendee has fully paid for the land. It sounds executory, under Countryman's test: vendee still has to pay and vendor still has to deliver title.[28] Whether executory or not, when the issue is rejection, the characterization should

27. 19 Bankr. 53 (Bankr. D. Utah 1982).
28. See *In re* Alexander, 670 F.2d 885 (9th Cir. 1982).

not matter. Outside of bankruptcy, if vendee defaults, the characterization of title retention by the vendor suggest that the vendor gets the property back, and that would be true even if the land was worth more than the contract price of (say) $100,000. Rejection in bankruptcy, even under section 365, carries the same consequences.

In many states land is sold through a somewhat different mechanism: title passes at the time of possession by the vendee, but the vendor retains a security interest in the land to secure payment of the purchase price. This kind of transaction is not executory under Countryman's test, because the vendor has no further obligations. Again, when the issue is one of rejection, it does not matter whether section 365 applies. Outside of bankruptcy, if the vendee defaults, the vendor can foreclose on the land. But if the land is worth more than the purchase price of $100,000, the vendee (in theory at least) gets to keep the excess.

Thus, when the issue is one of rejection, whether the bankruptcy characterization of the deal is as an executory contract or not should not matter because here section 365 acts in conformity with the general treatment of assets and liabilities in bankruptcy. Because of their different nonbankruptcy characteristics, however, the bankruptcy treatment of the two cases should be different upon rejection. In the case of a contract for deed, the vendor gets the property back. If it is worth $150,000 instead of $100,000, vendor, not vendee's creditors, gets that extra value.[29] In the case of the secured sale, however, the vendor has a secured claim for the purchase price of $100,000. Although the value of that is recognized in bankruptcy, vendee's creditors, not vendor, get the "extra" $50,000.

Who gets the $50,000, in other words, seems to be a quintessential nonbankruptcy distributional issue that bankruptcy law should respect and that use of section 365 itself would not affect. The court in *Booth*, however, decided that it would be "better" for the debtor's unsecured creditors to recharacterize the contract for deed as a secured sale, because the excess would then flow to the unsecured creditors, not to the vendor. It reached that conclusion by seeing section 365 as "an index to when assumption or rejection of a contract will 'benefit the estate' and therefore of when a contract is executory."[30] Since the general creditors would receive a greater amount of money if the contract were "viewed as a lien than as an executory contract," *Booth* recharacterized it, reasoning that "[t]he bankruptcy court, as a court of equity, regards substance over

29. Rejection might nonetheless occur, because, for example, the purchase contract carries with it an extremely high interest rate.

30. 19 Bankr., at 55. See also id., at 58 (citing Silverstein, supra note 21).

form, demands equality of treatment among creditors, and loathes a forfeiture."[31]

Although this recharacterization is popular,[32] it has nothing to do with the *effect* of using section 365 when the issue is one of rejection. *Booth* was not simply applying a different bankruptcy label and then using special powers of section 365, but rather it was substantively recharacterizing the underlying property right from a contract for deed to a secured sale. It was this change in the underlying substantive attributes of the transaction, not the use of section 365, that gained the surplus for the debtor's general creditors. That the *Booth* court viewed section 365 as the justification for a property recharacterization and that many other judges concur suggest how far that section has strayed from bankruptcy's normative underpinnings as a collective debt-collection device and how it invites others to stray with it.

31. 19 Bankr., at 58.

32. See, e.g., *In re* Adolphsen, 38 Bankr. 780 (D. Minn. 1983); *In re* Gladding Corp., 22 Bankr. 632 (Bankr. D. Mass. 1982). Not all courts agree: see, e.g., Shaw v. Dawson, 48 Bankr. 857 (D.N.M. 1985); *In re* Britton, 43 Bankr. 605 (Bankr. E.D. Mich. 1984).